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The Manufacturers Hanover
Economic Report
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Quarterly Business Conditions Analysis

The old saying that it is always darkest before dawn appears to apply to the state of the U.S. economy. Amid growing talk of gloom and doom, of a seemingly-endless recession punctuated by surprise business failures and the need for the monetary authorities to mount rescue missions, signs of recovery are beginning to appear. To be sure, such a recovery is unlikely to be vigorous or long-lasting like most of its predecessors over the postwar era. Nevertheless, it will mark at least a temporary end to the decline in economic activity that has been underway since summer, 1981.

Before going any further, it should be noted that even this feeble recovery requires that several key assumptions come to pass. These deal with the two elements of economic policy — fiscal and monetary — as well as with political conditions in the Middle East and climatic conditions on the nation's farms. If the assumptions spelled out below do occur, it is reasonable to anticipate expanding economic activity in the U.S. over the balance of the year — albeit at a slow and uneven pace.

Some Early Signs of Recovery...

Since regular readers of this Report can figure out what I think must occur regarding the assumptions referred to above, let me leave them for later, and discuss what might not yet seem apparent — the signs of economic recovery. First and foremost is that in the first quarter of 1982, sales to final consumers after adjusting for inflation rose significantly for the first time in a year. This is important for two reasons: it is a sign that there is a need to buy on the part of purchasers at the consumer, business and government level; and by eating into inventories, it hastens the day when assembly lines will run faster, thus increasing the need for labor, materials and machinery.

That inventories were eaten into is also apparent from the first quarter's GNP accounts. For the first time in a year, the inflation-adjusted level of unsold goods diminished in size. The quarterly decline appears to have been largest on record. Coming in the wake of the steep and prolonged drop in economic activity recorded earlier, this might not necessarily suggest that businessmen have whipped their stocks back into shape. However, it clearly indicates that much progress has been made.

Evidence of at least a modest need to restock comes from the Government's latest report on new orders for durable goods. Led by a 3½ percent jump in orders for nondefense capital goods, total hardgoods orders rose in March for the second straight month. This is the first time since summer 1981 that durable goods orders rose in two consecutive months. And because incoming orders outpaced shipments, durable goods producers reported an increase in their backlog of unfilled orders for the first time in half a year.

For this to carry forward beyond only a few months, it must be accompanied by increased strength in the consumer sector — and it was. While total real final sales were rising less than two percent in the first quarter, real spending by consumers alone jumped by nearly four percent. The increase was broadly distributed and included autos and parts, furniture, clothing, shoes and services.

To make matters even more interesting, consumers have the wherewithal to lift their outlays even further. As I pointed out in the March Report, people in the aggregate are in reasonably good financial shape. Employment levels are high, buying power is growing, use of credit is low compared with people's incomes, and household liquid assets are at record levels. And that's as of the start of the second quarter; comes midyear, incomes will get a lift from two additional sources. The ten percent reduction in personal taxes scheduled for July 1, along with the 7½ percent boost in Social Security benefit payments, will add another $45 billion to after-tax incomes.

Another, even more important fillip to buying power has already arrived in the form of the dramatic slowing of inflation. As recently as third-quarter 1981, consumer

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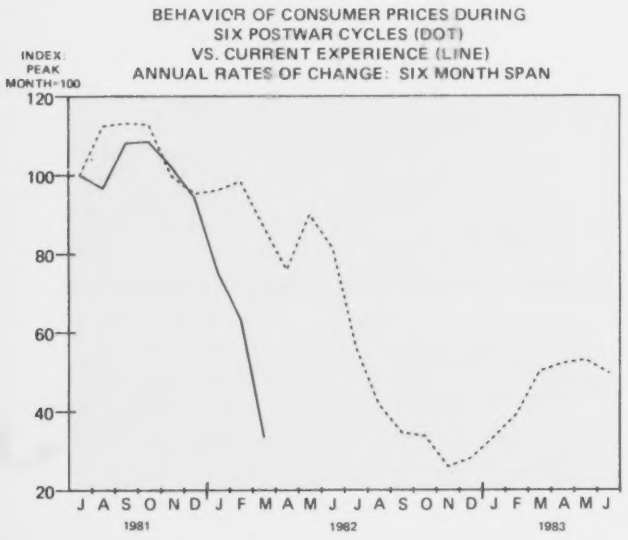
prices were rising at an annual rate of nearly 13 percent. Six months later, in the first quarter of 1982, the pace was down to only a 2½ percent rate of rise—with prices in March registering their first monthly decline in nearly 17 years and their largest month-to-month drop in almost three decades! Since wages continue to reflect earlier agreements, salary schedules and the like, the drop in the rate of inflation during the past half year—not to mention the actual decline in prices in March—has clearly given a substantial, and largely unexpected lift to people's buying power. Translated into the "real world" this means that more and more of us should be noticing a few dollars left over after paying the bills, and if the past is any guide, most of these dollars should find their way into the spending stream before long.

Less inflation will also help the economy at large. It will enable more real growth to be squeezed from the same increase in the money supply than would otherwise be the case. For example, the Federal Reserve believes that its 1982 target for growth in the money supply M1, as much as 5½ percent, is enough to support an increase in nominal GNP of around nine percent. If prices were to go up in 1982 by as much as they did in 1981, nearly nine percent, there would be hardly any room for real growth. But a continuation of the price trends of first-quarter 1982 would allow for more than five percent real growth!



Of course, there is a question as to whether this improvement in inflation will continue—especially if a recovery is, indeed, in the offing. I say it will. For one thing, as the chart shows, inflation tends to stay subdued for several years following the end of a recession. This is because of slack in both the labor force and in industrial capacity, as well as the productivity gains that usually arise during the early stages of recovery. For another, if one were to examine the sources of the slowing in consumer price inflation one would find that there is another reason to think that inflation will remain subdued. Most of the recent deceleration in the consumer price index traces to a decline in the cost of energy, and a stabilization in the cost and financing of housing. While the recessions both here and abroad undoubtedly contributed to the cut in energy usage, hence downward pressures on its price, a good deal also appears to trace to conservation, which is unlikely to change once recovery gets underway. As for housing, it will probably remain depressed as long as mortgage rates remain in the high teens, hence no upward price pressures are in store for this sector.

...But It May Be Feeble...

This brings me to the statement I made at the outset concerning the vigor and longevity of the oncoming recovery. The expansion is more likely to be a repeat performance of the rises in the real GNP that took place in 1979, 1980 and 1981—weak, and of short duration—as opposed to those of earlier years. This is because it will lack both first-stage and second-stage support vital to producing a sharp, sustained economic boom. For one thing, as noted above, the recovery will not get much help from homebuilding. Autos aren't likely to be major contributors either, unless Detroit cuts prices significantly. And exports will remain weak as long as the dollar is overvalued and economies abroad are soft.

Thus the first stage of recovery will have to come from consumer purchases of softgoods, "small-ticket" hardgoods and services—hardly the making of a robust upswing. The second stage will also lack a vital component—business spending. Plant and equipment outlays are unlikely to rise while idle capacity approaches 30 percent and the cost of borrowing money is in the mid to upper teens. What is more, because so many businesses are illiquid, their first use of any increase in incoming cash will be to restore liquidity and pay off some debt, rather than to invest in capital goods.

As you can see, since the recovery will be deprived of its normal sources of strength, it will require every bit of help it can get from adequate supplies of energy and food. Thus it is assumed that both energy and food prices will remain stable compared with other prices. This means, of course, no new war in the Middle East or elsewhere that would threaten oil supplies, and reasonably good growing weather in the farm belt.

Even more important is the need for an agreement between the Administration and the Congress to reduce the Federal budget deficit. This is needed in order to assuage the fears that now exist in the financial markets concerning the government's future borrowing needs in

the context of an unyielding monetary policy and an inadequate supply of savings in the private sector.

...And Could Easily Abort

The extent to which the projected deficit, hence Washington's borrowing requirements, is reduced over the next few years will be a major determinant of the level of interest rates, which, in turn, will have a direct bearing on how fast and how long the recovery lasts. It is generally agreed by both the Administration and the Congress that, left untouched, the deficit would swell to $180 billion in fiscal year 1983, $220 billion in fiscal year 1984, and $240 billion or more in fiscal year 1985. Were this to be the likely course of events, Washington's borrowing needs would soon appropriate all of the net savings that the economy generates and then some, as the table indicates. In anticipation of this lop-sided relationship between the demand for funds and their supply, money-market interest rates would bound upward to new records by midsummer — prolonging and intensifying the first quarter's drop in the real GNP.

FEDERAL AND FEDERAL-RELATED BORROWINGS VS. NET NATIONAL SAVINGS

Year	(1) Federal and Federal-Related Borrowings* ($ billions)	(2) National Net Savings** ($ billions)	Total Federal Borrowings as % of Savings
1960	5.6	29.0	19.3
1970	17.9	70.1	25.5
1980	124.3	169.9	73.2
1981	142.1	192.4	73.9
1982	206.0(3)	223.6(5)	92.1
1983	293.5(4)	259.8(5)	113.0
1984	322.0(4)	301.9(5)	106.7
1985	342.0(4)	350.8(5)	97.5

(1) Fiscal Year

(2) Calendar Year

(3) OMB estimate

(4) OMB/CBO estimate of Federal deficit with no budget compromise, plus off-budget spending of $30 billion, Federally-sponsored agency spending of $30 billion, and guaranteed loans of $42 billion.

(5) Increases 16.2 percent per annum during 1982-85 period, twice the rate of rise posted during the 1971-81 period.

* Federal and Federal-related borrowings are the sum of on- and off-budget (primarily Federal Financing Bank) outlays, borrowing by Federally-sponsored enterprises and Federally-guaranteed loans.

** Net National Savings equals gross private savings (corporate and household), plus state and local government surpluses and capital grants received by U.S. less net foreign investment and capital consumption allowances.

Sources: Treasury Department, Federal Reserve, Office of Management and Budget, Congressional Budget Office, MHT Co.

On the other hand, a compromise that cuts the deficit in half by or before fiscal 1985 would be favorably received by the financial markets. Under this circumstance, short-term interest rates could drop by as much as four points within a few months, then decline another point or two by yearend. Not only would real growth resume immediately, it would pick up steam with each downward movement in interest rates.

For purposes of forecasting, I am assuming neither extreme comes to pass. Rather, I have factored into our model some cuts in the projected deficit — but not as much as the markets would like to see. As a result, interest rates come down — but only slowly. In turn, this allows recovery to get underway before midyear — but at a feeble pace, one that could easily be aborted before yearend.

Never before has politics intruded so much on economics. And never before has an Administration followed such a controversial economic policy as the one it is pursuing today. While almost no one disagrees with the President's basic objectives of slowing the growth in government spending, reducing tax rates to stimulate savings and economic growth, and encouraging the Federal Reserve to conduct a non-inflationary monetary policy, it is the order in which these objectives were implemented that have caused so much concern — especially when projected increases in defense spending are added in. Taxes, hence revenues, have been cut and defense spending has been increased while Congress has yet to decide where to cut nondefense spending. Quoting from the Manufacturers Hanover Economic Report of November, 1980, "... any policy that calls for more spending and less taxes — regardless of what their classroom results might be — will in the real world widen an already swollen budget deficit ... causing either higher interest rates ... or more inflation."

We must consider the realities. While it might be nice to fantasize that the Congress will be forced to cut spending under the threat of huge budget deficits, the facts are that lack of money has not constrained Congress from spending in the past — witness the record. In the past quarter of a century Washington has run a budget surplus only twice — so why should Congress cut spending now, especially in an election year? Yet, all the publicity given the projected deficits is likely to cause Congressmen to think twice before spending any extra money that would flow back into Washington's coffers, were tax revenues to be "enhanced."

The U.S. economy is amazingly resilient. In spite of an unprecedented clash between monetary and fiscal policies which has produced the highest real interest rates in half a century and an equally as high level of business bankruptcies, we are once again poised on the threshold of economic recovery. Whether or not we make it, and for how long is in the hands of a few politicians in Washington. Let us hope they take the right steps — and soon.

April, 1982
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
in $ Billions

	< Actual		Projected >									
	1981		YEAR 1981		1982				YEAR 1982		1983	
	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II
Gross National Product	2965.0	2998.3	**2925.5**	**11.4**	2995.1	3021.0	3051.2	3095.7	**3040.8**	**3.9**	3129.4	3158.3
GNP: $72	1515.8	1498.4	**1510.3**	**2.0**	1483.6	1479.8	1489.3	1492.2	**1486.2**	**−1.6**	1500.9	1508.4
% Change, Annual Rates	1.4	−4.5	**2.0**		−3.9	−1.0	2.6	0.8	**−1.6**		2.4	2.0
Consumption	1883.9	1908.3	**1857.8**	**11.1**	1950.7	1967.9	1989.3	2003.1	**1977.7**	**6.5**	2031.3	2050.7
Durables	236.2	226.4	**232.0**	**9.5**	236.8	235.7	237.1	236.2	**236.5**	**1.9**	237.9	241.6
Non-Durables	751.3	760.3	**743.2**	**10.0**	766.1	770.1	772.0	767.0	**768.8**	**3.4**	777.5	781.0
Services	896.4	921.5	**882.6**	**12.4**	947.8	962.0	980.1	999.9	**972.4**	**10.2**	1015.9	1028.1
Investment	463.0	443.3	**450.5**	**14.0**	392.6	405.6	415.6	432.4	**411.6**	**−8.6**	433.8	445.6
Non-Residential	335.1	339.8	**328.8**	**11.1**	339.8	322.3	311.7	307.2	**320.3**	**−2.6**	313.0	316.6
Producers Durable Equipment	206.8	205.5	**203.1**	**8.6**	205.7	194.4	190.3	188.2	**194.7**	**−4.2**	195.7	199.9
Structures	128.3	134.3	**125.7**	**15.5**	134.1	127.9	121.4	119.1	**125.6**	**−0.1**	117.3	116.7
Residential	100.5	94.2	**105.5**	**0.3**	92.7	100.1	109.4	118.8	**105.2**	**−0.3**	122.1	125.1
Inventory Changes	27.5	9.4	**16.2**		−40.0	−16.8	−5.6	6.4	**−14.0**		−1.3	3.8
Net Exports	29.3	24.7	**26.0**		23.8	24.7	21.5	21.6	**22.9**		24.1	15.6
Government Purchases	588.9	622.0	**591 2**	**10.6**	628.0	622.8	624.8	638.5	**628.5**	**6.3**	640.2	646.4
Federal Defense	154.1	169.7	**154.3**	**17.2**	171.5	174.5	177.9	183.2	**176.8**	**14.6**	189.9	195.1
Federal Civilian	72.2	83.5	**75.9**	**12.9**	84.1	74.8	71.5	74.2	**76.1**	**0.4**	69.8	68.9
State & Local	362.5	368.7	**361.0**	**7.5**	372.3	373.5	375.4	381.2	**375.6**	**4.0**	380.5	382.5
Final Sales: $72	1500.9	1494.2	**1503.1**	**1.3**	1501.1	1487.4	1491.8	1489.6	**1492.5**	**−0.7**	1501.7	1507.0
% Change, Annual Rates	0.3	−1.8	**1.3**		1.9	−3.6	1.2	−0.6	**−0.7**		3.3	1.4
GNP Price Index (1972 = 100)	195.6	200.1	**193.7**	**9.2**	201.9	204.2	204.9	207.5	**204.6**	**5.6**	208.5	209.4
% Change, Annual Rates	9.9	9.5	**9.2**		3.6	4.6	1.4	5.2	**5.6**		2.0	1.7
PCE Deflator (1972 = 100)	195.7	199.3	**193.8**	**8.3**	201.8	203.3	204.2	206.3	**203.9**	**5.2**	207.7	208.9
% Change, Annual Rates	9.1	7.6	**8.3**		5.1	3.0	1.8	4.2	**5.2**		2.8	2.2
Consumer Price Index (1967 = 100)	276.2	281.4	**272.4**	**10.3**	283.6	285.3	286.8	289.1	**286.2**	**5.1**	291.2	292.9
% Change, Annual Rates	11.8	7.8	**10.3**		3.2	2.4	2.2	3.2	**5.1**		2.9	2.3
Total Personal Income	2441.7	2486.5	**2404.1**	**11.3**	2512.7	2534.7	2537.0	2580.8	**2541.3**	**5.7**	2596.8	2616.4
Disposable Personal Income	2042.0	2088.5	**2016.0**	**10.7**	2115.3	2135.8	2168.9	2202.2	**2155.5**	**6.9**	2210.7	2225.8
Savings Rate	5.2	6.1	**5.3**		5.3	5.4	5.8	6.5	**5.7**		5.5	5.3
Employment Rate	58.9	58.3	**58.8**		57.9	57.6	57.7	57.7	**57.7**		57.9	58.1
Unemployment Rate	7.4	8.4	**7.6**		8.8	9.2	9.3	9.4	**9.2**		9.3	9.2
Indus. Production (1967 = 100)	153.0	146.3	**150.9**	**2.6**	141.4	142.1	143.8	143.6	**142.7**	**−5.4**	145.9	147.2
Housing Starts (000)	961.7	865.3	**1099.8**	**−15.3**	918.7	997.5	1186.5	1316.2	**1104.7**	**0.5**	1257.7	1347.0
Domestic Auto Sales (000)	6933.3	5184.0	**6271.0**	**−4.9**	5966.7	5537.5	6135.7	6131.0	**5942.7**	**−5.2**	6035.0	6253.1
Corporate Pre-Tax Profits	234.4	212.8	**233.3**	**−5.0**	176.2	162.5	178.9	171.1	**172.2**	**−26.2**	175.0	174.1
− Taxes	78.1	68.8	**77.8**	**−5.6**	55.9	51.2	58.7	55.6	**55.3**	**−28.8**	53.8	53.1
Net Profits	156.3	144.0	**155.6**	**−4.7**	120.3	111.3	120.3	115.5	**116.9**	**−24.9**	121.3	121.0
− Dividend Payments	64.8	66.0	**63.1**	**12.7**	66.8	67.2	67.9	68.8	**67.7**	**7.2**	70.0	71.4
Undistributed Profits	91.5	78.0	**92.4**	**−13.7**	53.5	44.2	52.4	46.7	**49.2**	**−46.8**	51.3	49.6
+ Depreciation	187.7	194.9	**183.8**	**16.2**	202.0	211.2	220.5	230.0	**215.9**	**17.4**	237.4	244.3
− Inventory Profits	25.3	22.3	**27.7**	**−39.3**	10.6	4.8	2.2	0.4	**4.5**	**−83.8**	−3.4	−5.1
Net Cash Flow	253.9	250.6	**248.6**	**13.1**	244.9	250.6	270.7	276.2	**260.6**	**4.8**	292.1	299.0